OFFICE OF FAIR TRADING

Payment protection insurance

Report on the market study and proposed decision to make a market investigation reference

October 2006

OFT869

CONTENTS

[1] Annexes are available to view as separate documents on the OFT website www.oft.gov.uk/Business/Market+studies/payment.htm

1 EXECUTIVE SUMMARY

1.1 This market study looked at how well competition in the Payment Protection Insurance (PPI) market delivers choice and value to consumers. The purpose of this report is to set out the OFT's findings from the market study and explain why it is minded to refer the market to the Competition Commission (CC) for a market investigation.

The OFT's findings

1.2 PPI is a sizeable market with gross premiums estimated at £5.5bn. There are indications that consumers receive poor value in the low proportion of premium income paid out in claims (of the order of 20 per cent), and we have identified features of the market which adversely affect competition and appear to lead to poor value. The evidence suggests that how consumers purchase their PPI, their understanding of the product and the quality of information available to them hinders competition. We have estimated that the potential consumer savings from making the market more competitive could be around £1bn.

The case for a reference

1.3 The OFT is minded to refer the market for the supply of PPI in the United Kingdom. It is however minded to exclude store card PPI[2] from a reference to the Competition Commission (CC).The OFT has based its decision to consult on features of the market that might be preventing, restricting or distorting competition and thereby harming consumers. In deciding to consult on a reference, the OFT has taken account of the views expressed by insurers, distributors[3], intermediaries[4], trade associations and consumer organisations.

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[2] See paragraph 7.17

[3] Distributors include banks, building societies and other credit providers.

[4] Intermediaries include those who do not lend credit directly but arrange credit/PPI for their customers: e.g. brokers, catalogue companies, car sales companies, electrical goods shops etc.

1.4 In summary, our research has indicated the following features of the PPI market which cause concern:

How consumers purchase their PPI, their understanding of the product and the quality of information available to them hinders competition:

- consumers do not shop around for the best deal on PPI. A contributing factor to this is the huge point of sale (POS) advantage enjoyed by distributors
- the complex nature of PPI makes comparison between different policies difficult
- there is a lack of upfront (advertising) information on PPI i.e. before the consumer has decided to sign up for the credit, although the FSA's rules require firms to provide consumers with information about PPI in good time before the sale is concluded
- consumers display poor understanding of PPI, its price and the detail of their cover, with suppliers initially doing little to remedy this situation
- consumers appear only to consider the APR of the credit and not the cost of PPI or the cover it provides
- consumers in some cases either assumed or were told or given the impression by the distributor that taking out the PPI would help the application for credit.

While there may be competitive pressure operating at the upstream end of the market, we saw no evidence that this pressure is feeding downstream to consumers

- the POS advantage experienced by distributors means that there is little competitive pressure at the key point at which the consumer buys the insurance
- alternative products, such as income protection policies, are not direct substitutes in the sense of posing a constraint on PPI prices.

- stand alone[5] providers, who might otherwise be thought to offer a competitive pressure, have difficulty accessing consumers and face substantial start-up and marketing costs to attract custom

- present levels of cancellation or switching by consumers in this market do not exert any serious pressure on the prices of PPI.

There are indications that consumers are receiving poor value from their PPI:

- PPI has low claims ratios when compared to other insurance products, and with no evidence to suggest costs are high, it seems reasonable to assume that distributor profitability is sizeable with little evidence that this is being competed away

- commission rates paid by insurers to downstream intermediaries look high compared with other general insurance products

- the pricing of different PPI products cannot always be explained by differences in cover offered

- some unsecured personal loan providers, and possibly some credit card providers, are offsetting low margins on their credit offerings with profits generated from the sale of PPI, a less competitive market.

1.5 Under section 131 of the Enterprise Act 2002 (EA02), the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK. Section 131(2) states that a feature of the market is to be construed as a reference to:

[5] We interpret 'stand alone' as policies which are sold at a different time to the core credit transaction and by an organisation other than the lender involved in the core credit transaction i.e. are not sold as a 'linked' product to the credit.

(a) the structure of the market concerned or any aspect of that structure

(b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned, or

(c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

1.6 This does not mean that the OFT is obliged to make a reference in relation to every market which it believes meets the threshold set out in section 131. Rather, the OFT has a discretion whether to make a reference.

1.7 In guidance published in March 2003[6] the OFT said that it would make references to the CC only when the reference test set out in section 131 of the EA02 and, in its view, each of the following criteria have been met:

- it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT
- it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference
- the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it

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[6] OFT 511 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act'.

- there is a reasonable chance that appropriate remedies will be available.[7]

1.8 Chapters 6 and 7 set out our views on the features of the PPI sector in the UK that we believe may prevent, restrict or distort competition, and on how the criteria set out in our guidance apply and we propose to undertake a reference.

1.9 Under section 169 of the EA02, where the OFT is proposing to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact. This paper sets out our proposed decision and invites comments by **30 November 2006**. Comments should be sent to:

PPI Team
Markets and Projects
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London
Email- ppi@oft.gsi.gov.uk

[7] OFT 511 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

2 BACKGROUND AND METHODOLOGY

2.1 This market study has been carried out under the Office of Fair Trading's (OFT) function contained in section 5 of the Enterprise Act 2002.

2.2 The study was launched on 3 April 2006 in response to a super-complaint[8] on payment protection insurance (PPI) from the designated consumer body, Citizens Advice (CitA).[9] The super-complaint was received on 13 September 2005.

The super-complaint

2.3 The super-complaint was based on the CitA report 'Protection racket: CAB evidence on the cost and effectiveness of payment protection insurance'. In its super-complaint CitA stated that the evidence presented in its report suggests that features of the PPI market are seriously harming the interests of consumers. The issues and concerns raised by CitA are wide ranging. The super-complaint revealed four main areas of concern for the OFT to consider:

- consumers pay an excessively high price for PPI
- the protection consumers buy is partial, with many policies unreasonably excluding common causes of credit default
- consumers are frequently mis-sold PPI, with evidence of high pressure and unfair sales tactics

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[8] The right to submit a super-complaint was created by section 11 of the Enterprise Act 2002 (the Act). A super-complaint is defined under section 11(1) of the Act as a complaint submitted by a designated consumer body that 'any feature, or combination of features, of a market in the UK for goods or services is or appears to be significantly harming the interests of consumers'.

[9] The National Association of Citizens Advice Bureaux is designated by the Enterprise Act 2002 (Bodies Designated to make Super-complaints) Order 2004 (as amended) SI 2004/1517. (Citizens Advice is the operating name of The National Association of Citizens Advice Bureaux – see www.adviceguide.org.uk).

- the administration of PPI claims can be slow and unfair, and can leave consumers facing additional charges or serious debt enforcement action.

CitA's view is that these concerns arise because of a combination of market failure and regulatory gaps.

2.4 The super-complaint made the following specific recommendations to OFT:

- that OFT undertakes a market investigation into PPI[10]

- that OFT produces guidance for consumer credit licence holders on standards for sales and content of PPI policies they offer that would be consistent with fitness to hold a consumer credit licence

- that OFT takes regulatory action on PPI policies linked to hire purchase and conditional sale agreements, where borrowers exercising termination rights under sections 99 and 100 of the Consumer Credit Act are told that they cannot cancel the linked PPI or receive a refund of the premium or end any loan funding the premium early

- that OFT works with the Financial Services Authority (FSA) to develop a joint strategy for regulating PPI.

2.5 Section 11(2) of the Act requires the OFT, within 90 days after the day on which it receives a super-complaint, to publish a response saying whether it has decided to take any action, or take no action, in respect of the complaint and what action, if any, it proposes to take. The response must state the OFT's reasons for its proposal (section 11(3)).

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[10] Note: this is the wording used in the super-complaint. OFT can launch a market study under section 5 of the Enterprise Act 2002 or make a market investigation reference to the Competition Commission (CC) pursuant to section 131 of the Enterprise Act 2002 if it considers that the test for a market investigation reference is met. In respect of the latter the CC would carry out the market investigation.

OFT response to super-complaint

2.6 We responded to the super-complaint on 8 December 2005 with a commitment to carry out a market study. Our view was that a market study was the appropriate course of action because it gave us the opportunity to look more carefully at issues identified during the super-complaint which pointed to the sector not working well for consumers.

2.7 Furthermore, in considering our response to the super-complaint it was essential that we took account of work which was already underway at the time the super-complaint was submitted. The FSA's first thematic work on PPI (published on 4 November 2005) and the CC's report on its market inquiry into store cards, including store card PPI, which, was published 7 March 2006, were both key pieces of work and the timing of the super-complaint prevented us from fully taking account of their findings. The natural consequence was that we wished to undertake further work on the PPI sector beyond the date of the response to the super-complaint.

2.8 The issues we identified during the super-complaint which indicated the need for a more detailed examination were:

- consumers face difficulties in getting information they need about alternative suppliers and the information available is often too technical to be understood easily

- there are high costs or other barriers to entry for stand alone PPI providers

- there is a wide degree of variation in pricing in the sector without accompanying variation in quality

- gross profit margins appear high – PPI claims ratios are low compared to other general insurance products.

2.9 When launching our market study, on the 3 April 2006, we committed to examining the following issues:

- the relationship between the various players who supply PPI (lenders, insurers, intermediaries) and how this affects the sector
- how the product is sold to consumers and what influences their choices
- consumers' experiences of making claims
- the impact exclusions have upon consumers' ability to shop around
- consumer awareness and understanding of exclusions.

Methodology

2.10 In order to fully examine these issues, we carried out wide ranging research into the PPI market. The following are the key tasks which were carried out:

London Economics

2.11 We commissioned London Economics[11] to carry out research on, amongst other things, market structure and market definition and the identification of features within the PPI sector which might dampen competition. The resulting report helped inform OFT's considerations of market definition and contributed to the scope of the study. The London Economics report can be found at **Annex A**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

Consumer survey

2.12 GFK NOP carried out a consumer survey which consisted of both qualitative research (one to one depth interviews and focus groups) and a large scale quantitative survey covering all types of PPI. The quantitative stage of this work consisted of 1,005 telephone interviews

[11] London Economics are an economic consultancy, providing valuation, price forecasting, and market analysis on a broad range of sectors - www.londecon.co.uk.

with consumers who had taken out PPI – split into five types, credit card/unsecured loan/secured loan/first charge mortgage and store card PPI. GFK NOP also contacted 150 PPI consumers who had bought credit but rejected the offer of PPI for that product (to find out why they didn't take PPI) and 126[12] claimants (to find out their experience of claiming). The survey covered issues such as consumer understanding and behaviour (including why PPI was purchased, expectations of the product), information provision and availability (including whether the consumer shopped around for the PPI & how this compared to shopping around for the credit product) and the sales process – e.g. whether they felt pressured to buy, whether there was an assessment of eligibility/suitability. The report on that survey can be found at **Annexe B**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

Academic input

2.13 We commissioned an academic with a particular knowledge of PPI- Rob Ranyard, Professor of Psychology at the Department of Psychology and Life Sciences, University of Bolton to examine the findings from the consumer survey with a view to considering the psychological factors which might influence the consumer's decision to buy or not to buy PPI and, in the light of the survey findings, how might the consumer be supported and what might be done to facilitate informed PPI decision making. Professor Ranyard also contributed to the design of the consumer survey. Professor Ranyard's report can be found at **Annexe C**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

Business survey

2.14 An in-house questionnaire was issued to insurers, distributors and intermediaries shortly after the launch of the study. We estimate that

[12] Of those PPI holders that GFK NOP spoke to, only 126 had ever made a claim (only 38 claimed on a policy taken out since 2005).

responding firms (who were primarily insurers and distributors) account for, respectively, 83 per cent and 72 cent of the gross written premium earned in the PPI sector. In addition to the surveys, meetings were held with businesses/organisations from across the industry and we also issued financial pro-formas which aimed to determine where profits and costs lie throughout the supply chain. Summaries of the business surveys can be found at **Annexe D**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

'Mini mystery shop'

2.15 We carried out our own internal research to gather information on: the credit product including interest rates on the loans; the type of PPI premium (single/regular); loan/mortgage costs with/without PPI; total costs of PPI over the term of borrowing; APRs and exclusions. Using a variety of sources including websites, high street branches and telephone sales, we contacted 24 providers of unsecured personal loans, 10 first charge mortgage providers, 9 providers of secured loans and 10 providers of credit cards to find out information. A summary of the mystery shop can be found at **Annexe E**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

Stakeholders

2.16 A wide variety of stakeholders were consulted during the course of the market study including trade associations, the industry (insurers, distributors and intermediaries), consumer organisations and other government departments. A list of consulted parties can be found at **Annexe F**. The Annexes to this report are available on our website at www.oft.gov.uk/Business/Market+studies/payment.htm

Structure of report

2.17 The structure of the remainder of this report is as follows. Chapter 3 provides an overview of the PPI sector, including a look at the different players in the supply chain and the value of the market. Chapter 4

describes the regulatory framework, including a look at the FSA's role in this sector. Chapter 5 looks at market definition. Chapter 6 looks at the case for a reference in terms of the information received during our study. Chapter 7 outlines the legal basis for the proposed reference. Details of annexes have been set out above.

3 OVERVIEW OF THE PPI SECTOR

3.1 PPI protects a borrower's ability to maintain loan repayments should they be unable to keep up their repayments due to accident (A), sickness (S) or unemployment (U). These are the main risks covered by PPI policies; some unsecured, second charge mortgage, and credit card PPI policies also cover risk to life (L). Policies are available to protect most forms of personal credit, the principal ones being:

- first-charge mortgage payment protection insurance (MPPI)
- second-charge mortgage or secured loan PPI
- unsecured loan PPI
- credit card PPI
- store card PPI.

3.2 Typically, PPI cover is purchased at the same time as the credit agreement with both the credit agreement and insurance cover being arranged by credit institutions/lenders,[13] the vast majority of which are the high-street retail banks and building societies. On the whole PPI is not mandatory in the sense of being a prerequisite to a consumer obtaining credit. However, in the case of mortgages, some lenders may insist on MPPI as being 'appropriate' for certain types of consumers.

3.3 Once the credit product is agreed, PPI is available accordingly, reflecting the fact that PPI is a 'secondary' or even 'tertiary'[14] product (whose existence may only become known to the consumer at the point of sale).

3.4 Claims are generally payable in the event of a reduction or complete loss of income resulting from the main risks A, S or U, and is usually paid at monthly intervals for a period not exceeding 12 months (although a few

[13] Referred to as distributors in this report.

[14] For example, after the sale of a car, and the sale of the finance to pay for the car, the PPI is sold to protect the payments on the finance.

policies can pay out for 24 months). Loss of earnings resulting from factors largely under the control of the insured party (such as relationship breakdown, job dismissal or voluntary unemployment) is generally excluded by PPI policies. In most cases, policyholders cannot make a claim for an illness they already have or have had before (pre-existing conditions).

3.5 Common minimum eligibility requirements for PPI are that a consumer must be living and working in the UK, be aged at least 18 and under 65 years, and be actively employed for at least 16 hours per week and have been so for a specified period of time. PPI also entails terms and conditions relating to contract work and to borrowers that are self-employed, and there are also a number of conditions attached to the claims process itself, including specification of the period between purchase of the policy and when a claim can be made (the 'initial exclusion period') and the period between the risk occurring and cover commencing (the 'excess period').

3.6 Consumers purchasing PPI have a statutory cancellation period under the FSA's rules in which they can cancel their policy. This period is typically 14-30 days, but is usually 30 days.

Size and growth of the PPI sector

3.7 In terms of the size and growth of the PPI sector, it is estimated that the stock of live PPI policies in force is approximately 20 million and the sale of new policies is between 6.5 and 7.5 million annually.[15] By gross written premiums (GWP), the sector is estimated to have totalled £5.5bn[16] in 2005. On a compound annual growth rate (CAGR) basis, the value of total GWP rose by 18.8 per cent per year between 2000 and 2005.[17] Both the number of policies and the GWP data indicate a very rapidly growing sector – with a rate of growth that has exceeded

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[15] CitA report *Protection racket: CAB evidence on the cost and effectiveness of payment protection insurance*.

[16] Mintel UK *Creditor Insurance* November 2005.

[17] London Economics. *Research into payment protection Insurance in the UK*. April 2006.

that occurring in the personal credit sector over 2000-2004 (8 per cent).[18]

3.8 According to Mintel, within the PPI sector, the largest product area is personal (unsecured) loan PPI (which is estimated at around 60 per cent[19] of total GWP in 2005), followed by MPPI (20 per cent), credit card PPI (15 per cent) and car finance PPI (5 per cent). Like the overall sector, each of these areas of PPI has been growing very rapidly since 2000, with average annual growth rates of between 15 and 20 per cent during 2000-2005.

3.9 In terms of penetration i.e. the proportion of credit agreements also having a PPI policy, from our own business survey we calculated average penetration rates in 2005 of 72 per cent for second charge mortgages, 34 per cent for unsecured personal loans, 31 per cent for first charge mortgages, 13 per cent for credit cards and 26 per cent for store cards.

3.10 Estimated penetration rates from Datamonitor (2004) for 2003 are higher than the Mintel (2005) estimates for 2004 while those of Credit Suisse (2005) are in between. The following range estimates reflect the values reported in the three sources. The highest levels occur in unsecured personal loans (40-60 per cent of such credit agreements also had PPI in 2003/2004), credit cards (25-45 per cent) and mortgages (25-30 per cent) (for new mortgages 25-40 per cent).

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[18] London Economics. *Research into payment protection Insurance in the UK*. April 2006.
[19] Mintel UK. *Creditor Insurance.* November 2005.

Structure of PPI sector

Table 1: Market Shares of PPI Providers by GWP (2005)

PPI Provider	Market Share (per cent)
Norwich Union (Aviva)	19
UKI (RBS Insurance)*	15
Lloyds TSB (Lloyds Group)*	14
St Andrews (HBOS Group)*	13
Barclays Insurance (Barclays Group)*	12
Hamilton Insurance (HSBC Group)*	12
Cardif Pinnacle	6
Others	9

*Integrated providers

Source: Mintel (2005).

3.11 As table 1 above shows, according to Mintel, integration of underwriting and distribution of PPI (and credit) is a feature of the sector with vertically integrated providers accounting for over 60 per cent of the market. In addition a small number of insurance providers sell direct to intermediaries or consumers.

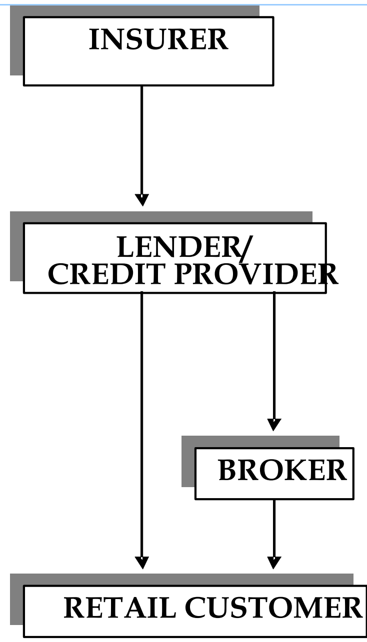
3.12 Insurers compete to provide PPI policies for distributors, which then sell these PPI policies alongside their credit agreements (personal loans, credit cards, mortgages etc.) to final consumers- often in return for commission and/or some form of profit share. The consumer's contract is with the insurer, who they would subsequently approach in the event of having to make a claim (alternatively, consumers may go through the intermediary who arranged their PPI).

3.13 A lender normally[20] appoints one insurer (whether it be an in-house or external insurer) to underwrite the PPI policies that it distributes with its

[20] In some instances some lines of insurance may be tendered separately, for example, the Life element.

credit products. Typically, this tends to occur through a tendering process[21], with exclusive contracts of 1-5 years being offered (on average 3 years). The numbers of insurers invited to bid can range from 2 to 14 (on average 3 bids).

Figure1: Organisation of PPI Sector in UK



Source: London Economics.

3.14 In selecting insurers lenders will generally have regard to price, quality of product and service, track record, reputation and logistics. Contracts may also include bonus agreements, profit-sharing arrangements and/or sales targets between lender and insurer (although qualitative evidence suggests that the latter are not widely used). With limited exceptions (see footnote 19), at any given point in time, lenders will deal with one insurer in providing the PPI products that they distribute with their credit agreements.

[21] This will differ for in-house business.

3.15 The distribution of PPI policies to consumers is largely controlled by the lenders, principal among which are the high-street retail banks and building societies, which together account for approximately 80 per cent[22] of all PPI policies sold. Their extensive branch networks and position as leading credit providers give them unique access to consumers, which is a key feature of PPI distribution.

New entry

3.16 The main entry requirements for insurers at the upstream end of the market relate to the distributor's requirements regarding the nature of the PPI policies it wishes to sell. These include solvency requirements and reputation (it may be important for a consumer to recognise the name of the insurer when he/she is taking out a PPI policy on a credit agreement). These requirements may not be significant in the case of an established insurer but may be more important to a *de novo* provider or a cross-border insurer from another country – there has not been entry for some time. Sterling Insurance and St. Andrews entered in the early 1990's and the latter is today part of the HBOS Group and accounts for 13 per cent of the PPI market as indicated in Table 1.

Stand alone providers

3.17 New entry has included stand alone providers, which tend to concentrate on MPPI, unsecured loan PPI and credit card PPI. Stand alone providers include British Insurance, BIBA, Payprotect and Paymentcare. They tend to operate mainly on-line. The data is less clear on how much of the market they account for with anecdotal evidence suggesting anything from 1-7 per cent. Research from the Council of Mortgage Lenders[23] suggests that direct sales currently occupy only 1 per cent of the market.

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[22] Mintel UK. *Creditor Insurance.* November 2005.

[23] www.cml.org.uk/cml/statistics

Product characteristics

MPPI

3.18 Mortgage payment protection insurance or MPPI refers to PPI on first-charge mortgages.

3.19 The principal risks covered under MPPI are: accident and sickness (AS); unemployment only (U); or accident, sickness and unemployment (ASU). According to the insurance industry, the availability of such 'modular' options – e.g. between full ASU or having AS or just U – indicates that MPPI products are carefully discussed with the consumer as part of the mortgage transaction and show a degree of supplier flexibility that may be advantageous for the consumer.

3.20 Most MPPI policies involve a monthly premium (also known as a regular premium) or an annual premium paid monthly. The cost is generally expressed as a percentage of the monthly benefit - £x per £100 of benefit.

3.21 MPPI represents something of a special case within the UK PPI sector. In the 1990s, both mortgage lenders and the Government were keen to see take-up of MPPI increase. The reasons related primarily to the changing socio-economic profile of mortgage holders which drew in more borrowers with a higher risk of unemployment; the recognition at the time that home-owners could no longer take for granted the stability and security of income that historically characterised owner-occupation; and the shift in Government policy away from sole reliance on the State for safety-net provision to forms of partnership with the private sector.

Second charge mortgage PPI

3.22 A second-charge mortgage is a secured loan which is guaranteed or 'charged' on the person's home and constitutes the 'second-charge' on the home.

3.23 The principal risks covered are life (L), accident and sickness (AS) and unemployment (U). The life cover generally pays off the outstanding

balance on the loan in the event of a claim. The ASU cover provides a monthly benefit equal to the loan repayment outstanding. The AS benefit may be paid to the term of policy or it may be limited to a maximum number of months. Payment of the U benefit is generally limited to 12 months per claim.

3.24 PPI policies on secured loans generally involve a single premium paid up front for the term of the policy, which is commonly 60 months. The premium is generally calculated as a percentage of the loan. Results from our business survey indicate that 93 per cent of the PPI sold with secured loans is single premium.

Unsecured loan PPI

3.25 Unsecured loan PPI is the single largest product area within the UK PPI sector. This area includes personal loans (e.g. for holidays, home improvements), motor loans (from credit institutions as well as from car dealerships) and hire purchase (HP) agreements. PPI offered with unsecured loans is usually single premium, which is charged at the outset of the loan. It is calculated as a percentage of the loan plus the interest charges. Thus, whilst the consumer may pay the premium in 'cash', it is usual for the premium to be added to the amount of the loan and repaid over the term of the loan. This means that interest at the loan rate is charged on the PPI premium.

3.26 If the underlying loan is settled during the term of the policy or the premium cancelled, a refund of premium will usually be given. The basis of calculation will vary but it reflects the fact that the insurer's liability reduces as the term of the loan progresses. The FSA believe that refunds of single premium should be based on reasonably incurred costs of the consumer cancelling early. The FSA has indicated, and trade associations have agreed, that firms should not include nil refund terms in their PPI policies when a consumer cancels a policy for any reason, except where a claim has already been paid under the insurance policy or the consumer has instead chosen to take continuing PPI cover for another loan.

3.27 Since May 2005, consumer credit agreements must carry two signatures[24] from the consumer to indicate agreement to the original amount of the loan and the extra cost of the PPI associated with the loan.

3.28 The principal risks covered in the case of unsecured loans are life (L), accident and sickness (AS) and unemployment (U). Typically one product covers all such risks although there are also 'modular' products that enable the consumer to choose the sections of cover they require.

Credit card PPI

3.29 The purpose of credit card PPI is to cover a percentage of the insured's outstanding balance should he or she be unable to work through accident, sickness or unemployment. The principal risks covered are life (L), accident and sickness (AS) and unemployment (U). The ASU cover provides a monthly benefit equal to a percentage of the outstanding balance at time of claim or on the monthly statement prior to the claim. This is most commonly 10 per cent but it can be 5 per cent or 3 per cent. The benefit period is typically for up to twelve months for unemployment and accident and sickness. The waiting period is usually 30 days.

3.30 Where life and/or critical illness cover is offered, the amount of cover will be equal to the total amount outstanding at the time of the insured event. The maximum period for which AS benefit is paid is generally related to the size of the monthly benefit. If it is 10 per cent, it is likely to be 12 months; if it is five per cent, it is more likely to be 18-24 months; if it is three per cent, benefit will be paid until the outstanding balance is paid off. The maximum payment period for U benefit is generally 12 months. The premium is charged monthly and is calculated as a percentage of the outstanding balance on the monthly statement.

[24] The second signature is only required if the PPI is financed by credit - not if it is payable in cash or on a rolling basis. PPI on credit cards and store cards will typically be payable monthly, in arrears, and so will not constitute 'credit'. As such, there is no requirement for a second signature on the credit agreement.

Store card PPI

3.31 The purpose of store card PPI is to cover a percentage of the insured's outstanding balance should he or she be unable to work through accident, sickness or unemployment. Store card PPI may also cover the insured's outstanding balance in the event of death or critical illness (where included or selected).

3.32 Store cards are not the same as credit cards. Store cards are plastic cards that are branded with a distributor's name or trademark, which can be used for payment or credit **only** in that distributor's outlets and, in the case of co-branded store cards, in outlets of other 'accepting' distributors.

3.33 The principal risks covered by store card PPI are life (L), accident and sickness (AS) and unemployment (U). Purchase and/or price protection may also be included within the store card PPI product and/or provide cover against accident, loss or theft of the item for a limited period of time and allow the consumer to claim if the item is offered by the store at a lower price within a certain period of time after purchase.

3.34 The premium is charged monthly and is calculated as a percentage of the outstanding balance on the monthly statement.

4 REGULATORY CONTEXT, FSA ROLE AND CONSUMER PROTECTION

Market dynamics / consumer protection

4.1 In the PPI sector OFT and the FSA have complementary regulatory roles. The OFT has the lead role in considering whether markets are working well in terms of delivering value for consumers (although the FSA does also have an interest in this area). The FSA has the lead role on consumer protection issues within its regulatory scope including selling practices and regulation in the market (although the OFT has an interest as the primary regulator of credit [to which the PPI is linked], in enforcement of the Consumer Credit Act 1974 (CCA) rules relating to the PPI aspects of credit agreements and responsibilities for consumer credit licensing).

OFT regulation

Consumer Credit Act 1974 – licensing

4.2 OFT does not regulate the sale of PPI: that is the responsibility of the FSA. The OFT, however, under the CCA, licenses those involved in the sale of the credit which the PPI is sold to protect. The CCA applies to brokers and other intermediaries as well as those who offer credit or lend money directly. These include retailers who simply arrange credit for their consumers using the services of a finance company.

4.3 Licences are only issued and retained if the OFT is satisfied that the applicant is a 'fit person' to hold one. The OFT can take into account anything considered to be relevant to a person's fitness.[25] For example, pressure selling of PPI, pursuing debts and adding charges when waiting for insurance payments may amount to conduct inconsistent with fitness. If the OFT receives evidence that a licensee is not a fit person

[25] The Act does not give an exact definition of 'fitness' but it requires the OFT to take into account any circumstances which we consider relevant (s25(2)). This provides the OFT with wide discretion to take account of misconduct.

after a licence is issued, it can revoke, suspend or change the terms of the licence.

Consumer Credit Act 1974 – advertising and agreement requirements

4.4 As well as establishing the licensing regime, the CCA regulates the form and content of credit advertisements and credit agreements. The regulations can affect how PPI is advertised and how PPI contracts are documented.[26] For example, where PPI is to be financed by the credit on offer, a separate signature box for the PPI is required on the credit agreement. Under Part 8 of the Enterprise Act 2002, the OFT and other designated enforcers can take enforcement action against breaches of the CCA regulations that affect the collective interests of consumers.

4.5 To help business comply with the CCA regulations, the OFT produces guidance on how the regulations apply in practice. The OFT also monitors the effects of the regulations and provides feedback to Government on how the regulations may be improved to ensure transparency and clarity for consumers.

FSA regulation

4.6 Since 14 January 2005 the FSA has been responsible for the regulation of non-investment insurance, sales and administration, including PPI.[27] The FSA's overall aims are to help retail consumers achieve a fair deal; to promote efficient, orderly and fair markets; and to become more efficient and easier to deal with. The FSA has developed the Insurance Conduct of Business (ICOB) rules which brought in a range of regulatory rules including product disclosure, regulation of the sales process and complaints procedure.

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[26] Consumer Credit (Agreements) Regulations 1983 as amended by the 2004 Amendment Regulations and the Consumer Credit (Advertisements) Regulations 2004.

[27] The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment)(No2) Order 2003 SI2003/1476.

FSA's first thematic review

4.7 The sale of PPI was one of the thematic priorities set out in the FSA's 2005/06 Business Plan for their first year of general insurance regulation. The FSA published their first thematic review on 4 November 2005. The focus of this work was to assess whether firms were complying with FSA rules, particularly its ICOB requirements and training and competence rules, and whether firms were treating their consumers fairly.

4.8 The findings from this work were variable, with some firms, particularly those selling prime mortgages, demonstrating good compliance with the FSA's rules. However, in other sectors selling practices were poor and some firms lacked proper compliance controls. The key findings[28] from the FSA's first thematic review were:

- there was a risk of inappropriate sales: around half of the firms failed to take reasonable steps to ensure that consumers did not buy policies on which they could not claim or which provided only very limited cover

- there were inadequate controls in place for non-advised sales: about half of the firms selling on a non-advised basis did not have adequate systems to stop their staff giving advice or were providing information that amounted to giving advice

- advice on PPI was often likely to be poor: most firms did not have systems in place to assess consumers' suitability for the product adequately

- there was an over-reliance on product documentation given to the consumer at the expense of explaining the policy to the consumer

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[28] The first thematic review findings suggest that the 15 firms sampled that sell regular premium PPI in the prime mortgage sector generally had better levels of compliance with the FSA's rules compared to the other sectors (revolving credit, unsecured lending and sub-prime mortgages/secured loans) and so they posed a lower risk. Because of this, the majority of the FSA's findings relate to the 30 firms operating in these other sectors.

orally: most firms selling by telephone did not give sufficient information on exclusions

- the quality and timeliness of product and price disclosure by some firms selling single premium policies was poor
- the level and structure of inducements and targets for sales staff could encourage mis-selling in some firms
- training and competence of sales staff was not adequate in around half of firms
- compliance monitoring was variable and in some cases very poor.

4.9 The FSA was particularly concerned about the selling practices relating to single premium policies.[29] Information on interest was not disclosed, insufficient information was given on the lack of refunds, and in some cases misleading comparisons were made between single and regular premiums in favour of single premiums.

4.10 The FSA's findings also suggest that compliant and fair selling practices are made all the more difficult because of the way in which PPI contracts are designed.

Industry response to the first thematic review

4.11 Following the FSA's first thematic review they invited trade associations, at a meeting on the 19 December 2005[30], to consider what action the industry could take to address both the compliance failings the FSA had identified and the wider competition issues in the PPI market.

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[29] See 5.6 to 5.13 of the FSA Thematic Work.

[30] Follow-up meetings were held on the 6 April and 31 July 2006 which gave updates on the progress made. Notes of both meetings can be found on the FSA's website at: www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2006/ppi_310706.shtml

4.12 The FSA continues to liaise with trade associations on their commitments which include:

- provision of guidance on improved sales procedures and training
- improved consumer information – this includes producing a consumer guide on PPI and working with consumer organisations and relevant bodies to distribute the information to consumers
- on single premium policies – an appropriate refund to consumers where PPI contracts are cancelled early
- an aim to standardise information on price and key product features – including consideration of the adoption of common terminology
- ensuring consistency of interpretation guidance - revised guidance on interpretation on contract clauses and claims handling, and development of minimum standards
- offering baseline MPPI products – to provide consumers with a minimum set of standards on MPPI products.

4.13 The FSA acknowledged that these measures should have a beneficial effect on the market. However, they highlighted that the focus of the commitments was on disclosure material that consumers may or may not actually read and that these proposals do not address the broader competition issues that had been identified.

FSA's second thematic review

4.14 The FSA undertook a second round of thematic work in 2006 to check whether the levels of compliance with their rules had improved. The findings of the FSA's second thematic review are due to be published in October 2006. In essence, while the FSA witnessed improved levels of compliance in several of the firms visited, the FSA identified aspects of the sales process where firms continue not to act in the best interests of consumers and treat them fairly.

4.15 In the light of the findings from the FSA's second round of thematic work and the outcomes from our market study, the FSA has said that it will examine the case for further regulation of PPI sales. Any further regulation would be subject to a full cost benefit analysis and public consultation and take into account the impact of the industry's own efforts to improve standards. This analysis will be carried out as part of the FSA's review of the *Insurance: Conduct of Business sourcebook*. The FSA intends to publish a report on the results of its review in Q1 2007, to consult on rule changes that arise from the review in Q2 2007, and to make any rule changes in Q4 2007.

FSA/OFT joint work on regulation

4.16 The OFT and FSA announced, in April 2006, our intention to collaborate more closely together on matters of joint regulatory interest.[31] Both organisations recognised that we have different, but complementary, powers and statutory objectives and a closer working relationship on areas where our interests overlap would reduce administrative burdens on firms, improve the way in which we make information available to consumers and deliver risk-based regulation – each key objectives of the Hampton Report.

4.17 An action plan produced on 28 April 2006 set out how we could deliver benefits to consumers and firms by working more closely together. The plan aims to:

- enable firms to provide standard information to both our organisations with as little duplication as possible

[31] A footnote in the Hampton Report published on 16 March 2005 queried whether regulation of consumer credit should pass to the FSA. Following consultation with a range of stakeholders, on 22 March 2006 the government announced that in light of recent and ongoing changes to the consumer credit regime, it did not propose additional reforms of the regime at this time. On the same day, a Joint Statement of Intent was published by the OFT and FSA announcing our intention to collaborate more closely.

- ensure that our policy and rules in areas of overlap are consistent and complementary, and thus easier for firms to implement

- give consumers a clear, easy to understand message in areas where our responsibilities overlap

- share knowledge and expertise more effectively; and

- ensure that everything we do is cost-effective for jointly regulated firms.

4.18 PPI is a good example of the joint regulatory strategy working in practice. The OFT and the FSA both have a strong interest in the operation of the PPI sector and, accordingly, we have worked closely to ensure a joined up approach to this sector. This approach addresses the CitA super-complaint recommendation for both regulators to develop a joint PPI strategy.

4.19 The consumer protection issues discovered during the course of our study, and set out in the annexes attached to this report, are primarily for the FSA to act upon, therefore, we have not addressed them in this market study report[32]. However, our findings may be useful to the FSA in shaping its consumer protection policies and we have discussed these with them accordingly.

[32] As the consumer protection issues identified by this study fall within the scope of FSA's regulatory responsibilities the OFT is not at this time intending to act on CitA's super-complaint recommendation to issue guidance to consumer credit licence holders on the sale and content of PPI polices. The FSA are also looking at the refund of single premium PPI upon early repayment of the associated loan and cancellation by the consumers of the PPI policy, which is relevant to CitA's recommendation on cancellation and refunds. Details of this work has/will be published in the FSA's report on the second round of thematic work on PPI.

5 MARKET DEFINITION

5.1 In making a reference to the CC, the OFT's guidance says that we must give 'some consideration to the definition of the relevant market', but 'the effects on competition of some features may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.[33]

5.2 Market definition is not an end in itself but a key step in identifying the competitive constraints acting on a supplier of a given product or service. Market definition provides a framework for competition analysis.

5.3 In brief, the relevant market comprises all those substitute products/services and regions providing a competitive constraint on the product/service and region of interest.

Product market

5.4 PPI is a secondary product. The OFT's Guidelines[34] consider the market for a secondary product to be a product (here, PPI) that is purchased only as a result of buying a primary product (here, credit). We distinguish between three possible relationships between the primary and secondary products in the definition of an aftermarket:

i) **System market:** a unified market for the primary product and the secondary product. In a system market the buyer will consider the combined price of the primary and secondary product[35] before deciding which products to purchase. It is not necessary that every consumer buys a bundle. What is important is that there are sufficient numbers of consumers purchasing the bundle (having

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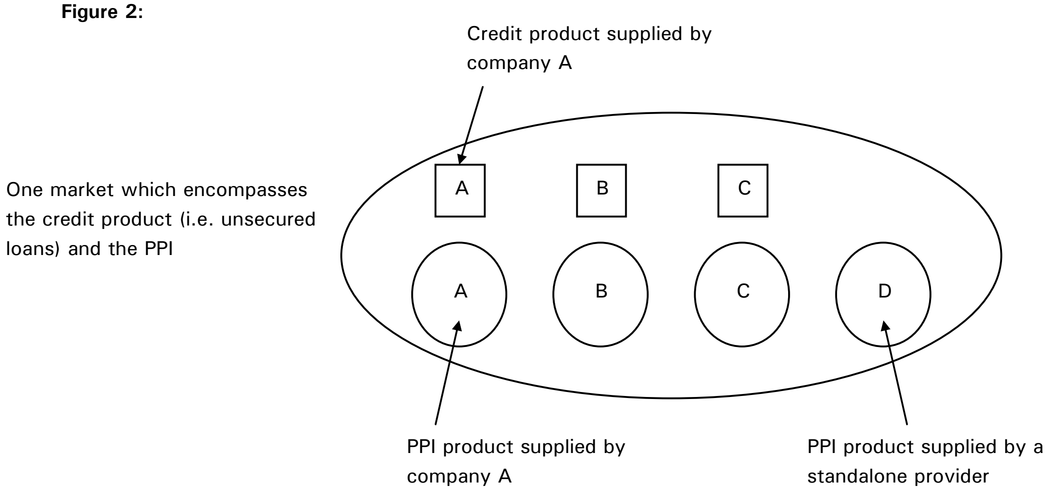
[33] OFT 511, 'Market Investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 4.8.

[34] OFT 403, Competition Act 1998 Guideline on Market Definition, paragraphs 5.4 to 5.11.

[35] This may involve an element of 'whole life costing' of the secondary product, e.g. ink cartridges.

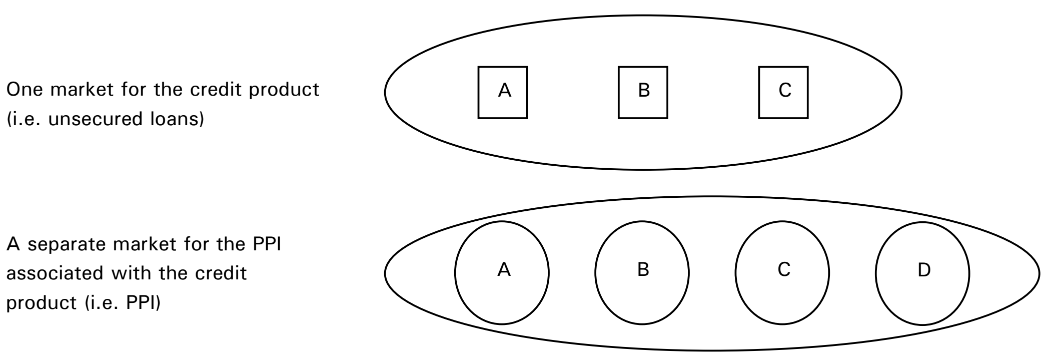
searched the market) to encourage the firm to competitively price the primary and secondary product as a bundle (see figure 2).

Figure 2:



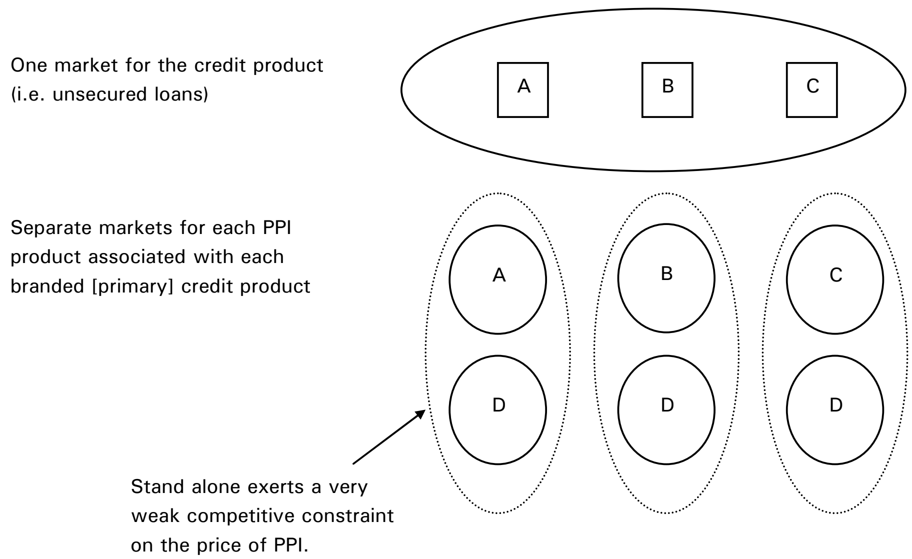
ii) **Dual market:** a market for the primary product and a separate market for the secondary product (see figure 3); and

Figure 3:



iii) **Multiple market:** a market for the primary product and separate markets for the secondary product(s) associated with each primary product (see figure 4).

Figure 4:



5.5 Which definition applies depends on the extent to which competition to supply the primary product constrains the price charged for the secondary product[36], and also on the degree of post sale consumer lock-in or switching inertia.

5.6 Using the aftermarket framework, we have adopted a two stage process when thinking about market definition.

5.7 First, separate primary markets can be defined (primarily on demand-side considerations) for credit cards, store cards, unsecured loans (personal loans, motor loans, and hire purchases), secured loans (excludes mortgages and re-mortgages), and mortgages on the basis of differing: term structure, loan amount, security, APR, purpose etc. This

[36] In other words, do consumers consider the price of the secondary product when shopping for the primary product?

is broadly consistent with the view taken by the Competition Commission in the Abbey National/ Lloyds TSB merger inquiry[37].

5.8 Then, given that the credit purchase opens up the PPI purchase, it seems likely that separate, secondary PPI markets exist for each credit product:

- first charge mortgage PPI
- secured loan PPI
- unsecured loan PPI
- credit card PPI, and
- store card PPI.

5.9 Depending on which secondary market structure exists, markets could be defined more narrowly still. If PPI currently operates as a multiple secondary market, for example there would be a market for HSBC MPPI, a separate market for Lloyds MPPI, and so on and so forth. However, it may be that different forms of PPI currently operate differently in the secondary market – for example some may tend towards dual markets, others multiple or even system. We are not required to reach a final view on the precise type of secondary market operating in each case, and have not done so.

Individual product market analysis

5.10 The broad competitive characteristics of the markets for PPI on unsecured loans, secured loans, store cards and credit cards are sufficiently similar to allow us to combine their discussion, although their product markets remain distinct. First charge mortgage PPI is discussed separately because it appears to operate slightly differently to the other markets.

[37] www.competition-commission.org.uk/rep_pub/reports/2001/458lloyds.htm#full

Unsecured loan PPI, secured loan PPI, store card PPI and credit card PPI

Supply side considerations

5.11 On the supply side, the majority of PPI policies in these four markets are sold by lenders or credit intermediaries. Stand alone players are not a significant aspect of these markets.

5.12 The main obstacle to entry for PPI providers appears to be consumer access and this reflects the fact that most PPI policies are offered at the point of sale of the (primary) loan agreement.

5.13 The consumer survey reveals that overall 88 per cent of PPI holders took out PPI at the same time as their credit product (thus presumably accepted the PPI product that was sold by the credit provider). The breakdown is as follows: 98 per cent for secured loans, 91 per cent for unsecured loans and 83 per cent for credit cards. This is reinforced by the industry that indicated in our business survey that over 90 per cent of PPI policies are sold at the POS of the credit product being insured.

5.14 Of those who didn't take out their PPI at the same time as the credit, overall 73 per cent took out the PPI product offered by the credit provider at a later date. This is 67 per cent for secured loans, 79 per cent for store cards, 79 per cent for unsecured loans and 94 per cent for credit cards. This emphasises the point of sale advantage of the incumbent PPI provider that has established a sales relationship with the credit provider.[38]

5.15 Consumer access is particularly important in the case of credit card and store card PPI, for which the card issuer may be the only party in possession of information on the outstanding balance on the card, which is critical to setting the premium and calculating the claim payments. Any PPI product not sold by a card issuer would need to

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[38] Please note a low number of respondents (95) answered this question and this result should be considered with caution.

define cover and collect premiums on a different basis, e.g., on balances up to some predefined limit.

Demand side considerations

5.16 In all four markets consumer search and demand side substitution between PPI products appears to be low. Businesses we spoke to indicated that the majority of consumers do not consider buying a PPI policy until it is mentioned at the point of the credit sale. Consumers only seem to shop around for low APRs on the credit product, rather than the cheapest combination of the credit and PPI.

5.17 This behaviour is symptomatic of the fact that the information relating to the PPI product is complex (a finding of our mystery shop survey). Moreover, a high degree of PPI product differentiation[39], limited outside options (stand alone products) and extremely low advertising levels makes comparison between products very difficult and costly.

5.18 Product compatibility issues and costly search – PPI is rarely advertised - also significantly limit the scope for switching post sale. Unsecured loan PPI and secured loan PPI may feature additional switching costs associated with the fact that most of these policies are sold as single premium policies. Consumers do not generally currently receive pro rata compensation for early termination of a PPI policy with single premium policies. That is, consumers switching between unsecured loans or second charge mortgages cannot switch the PPI easily.

System market qualities?

5.19 One lender has argued that the unsecured loan PPI market has system market properties. They argued that most lenders take a holistic approach to price setting: 'the APR's on loans are based on what consumer characteristics reveal about the expected risk of default and likely PPI take-up on the portfolio.'

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[39] Differences in the coverage, the product exclusions, and the way benefit accrue and are paid.

5.20 We are unconvinced that the unsecured loan PPI market is akin to a system market. Simply because a firm chooses to take a holistic approach does not mean that there is a competitive constraint acting on the price of the PPI. The same lender submitted that 'most consumers do not consider the benefits of PPI and the risks they are insured for until they are explained during the sales process', and this was confirmed by our consumer survey.

Conclusion on unsecured loan PPI, secured loan PPI, store card PPI and credit card PPI

5.21 With very little demand or supply-side substitution, we believe that separate markets for unsecured loan PPI, second charge mortgage PPI, credit card PPI and store card PPI exist.

First charge mortgage PPI

5.22 The first charge mortgage PPI (MPPI) market seems to operate slightly differently from the other PPI markets. The existence of stand alone products and a greater role for financial intermediaries (brokers etc.) might result in less of a point of sale advantage for the distributors of the credit.

Supply side considerations

5.23 On the supply side, stand alone products are a more prominent aspect of MPPI than in other PPI markets. That said, MPPI products sold alongside mortgages still have around 95 percent of the total MPPI market. Stand alone providers include British Insurance, BIBA, Payprotect and Paymentcare. They tend to operate mainly on-line.

5.24 Some providers such as Marks and Spencer, Norwich Union and AXA have tried to sell stand alone PPI policies direct to consumers but have subsequently withdrawn. Their withdrawal and the limited penetration accounted for by other stand alone suppliers seems to stem from a combination of low consumer demand (consumers generally do not rate PPI as an important financial product) and the high fixed costs of the marketing needed to overcome the lack of direct access to consumers.

5.25 Intermediaries are an important aspect of the MPPI market. MPPI sold via intermediaries increased from 14 to 21 per cent between 2000 and 2004 (CML). We considered whether such intermediaries are facilitating competition by shopping around for the best deal for the consumer, acting in a similar fashion to Independent Financial Advisors (IFAs) in relation to investment products. If correct, then the MPPI market would be exhibiting some of the characteristics of a dual market. At least one insurance firm noted that many intermediaries act in a similar way to lenders - i.e. they do not offer consumers a choice of PPI products. Anecdotal evidence from other stakeholder meetings corroborates this viewpoint. It seems that on the whole intermediaries sell the PPI products linked to the credit rather than picking from, say, a panel of suppliers.

Demand side considerations

5.26 On the demand side, it would appear that the point of sale advantage is weaker for MPPI than for other PPI lines. A few MPPI consumers seem to be more price sensitive than consumers of other PPI products, and tend to shop around for a good MPPI deal. This is probably because the MPPI premium represents a large share of a consumer's budget, and more stand alone alternatives exist.

5.27 In terms of switching, exit costs for regular premium policies are lower compared with single premium policies. The consumer survey shows that 14 per cent of MPPI holders successfully cancelled. Of these less than half reported that they switched to another MPPI[40] provider. Anecdotal evidence suggests that most of these consumers are likely to have switched because they have changed mortgage providers.

[40] To be considered with caution as the base is just 35 MPPI holders.

Conclusion on MPPI

5.28 Nevertheless, on the basis that the stand alone market is small and that intermediaries don't appear to be facilitating competition, we believe that the characteristics of the MPPI market are sufficiently similar to other forms of PPI that we have included it in our consideration.

Sub-prime MPPI – a separate market?

5.29 We have considered whether sub-prime[41] MPPI might constitute a separate market to prime MPPI, but whilst we found that there are a number of differences between the `sub-prime' and `prime' products, distributors and insurers have told us that they do not draw a distinction in a way that would indicate a clear structural break between the two. We have not, therefore, defined a separate market for sub-prime PPI on the basis of supply-side substitution.

Potential substitutes to PPI

5.30 We have also considered a number of potential demand side substitute products for PPI. Potential substitutes must be considered close enough by consumers to constrain the price of PPI.

5.31 The three main potential alternatives to PPI are life cover, critical illness cover and income protection (IP). All differ from PPI in terms of benefit, term, exclusion period, eligibility, application process and pricing (PPI is underwritten on a group basis). IP is arguably a substitute for mortgage PPI. However, it does not cover against death and unemployment, payments are taxable and can affect benefit payments, and the monthly repayments are made up to a selected age whereas those of PPI are usually limited to 12 to 24 months.

5.32 Hybrid products, for example the Post Office's 'lifestyle' product (a short term income protection product) might be an effective substitute for PPI. However, it is too early to say if such products will be sufficiently successful so as to constrain the prices of PPI.

[41] Sub-prime first charge mortgages represent a small part of the first charge mortgage market.

5.33 Overall we do not believe that any of the aforementioned products exercise a sufficient constraint on the price of the PPI products so as to be considered an effective substitute.

Geographic market

5.34 In addition to the definition of the relevant product market(s), there is also a question of the relevant geographical market(s) in consulting on a reference. The conditions of supply and demand are to some extent determined by the regulatory framework, which applies to the UK. Further there is no evidence of insurers or distributors partitioning the markets geographically. We therefore take the relevant geographic market to be at least as wide as the UK.

Market definition conclusion

5.35 It seems likely that the following five UK wide PPI markets exist:

- first charge mortgage PPI
- secured loan PPI
- unsecured loan PPI
- credit card PPI; and
- store card PPI

5.36 We emphasise that these comments only give an overview of the possible relevant economic markets, defining them no more narrowly than is necessary. A central task for the CC in any investigation would be to come to its own view of the appropriate market definitions.

6 SUMMARY OF ISSUES AND THE CASE FOR A REFERENCE

6.1 PPI can provide worthwhile cover against unforeseen events that cause repayment difficulties. It can offer valuable peace of mind whether or not a claim is made.

6.2 However we are concerned that there are features of the market that adversely affect competition and lead to poor value for consumers.

6.3 In this chapter we have set out the issues that have emerged from the market study which give us cause for concern, a number of which are evidence of features of the market which we believe prevent, restrict or distort competition. There is also other evidence indicating a lack of competition. These are under three headings: **How consumers buy PPI; Competitive pressure on prices and; Value for consumers.**

6.4 Where the threshold for a reference is met, the OFT's guidance on the exercise of its discretion[42] says that in assessing whether the adverse effects of features of a market on competition are significant, we will consider whether they are likely to have a significant detrimental effect on consumers through higher prices, lower quality, less choice or less innovation. We have considered this question throughout the analysis of the features of the markets that follows.

6.5 The issues in the following chapters exist across all of the sectors we have identified i.e. credit card, unsecured loan, first charge mortgage and secured loan PPI, albeit they may be less marked in some of the five individual retail PPI market sectors.

How consumers buy PPI

6.6 Where consumers are well informed, and able to choose without facing undue sales pressure, they are in a position to make efficient choices. Their purchases will provide useful information to sellers about consumer preferences, which can then provide signals to potential

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[42] OFT 511, Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.27.

entrants and possibly stimulate innovation. In the absence of such information, or under such sales pressure, markets may fail to work effectively, and price competition and quality of service may be reduced, even where there are many firms operating in the market.

Poor upfront information

6.7 Our research found a lack of upfront (advertising/marketing) information i.e. before the consumer has decided to sign up for the credit (and the PPI), which makes shopping around for PPI all the more difficult. We noticed during the course of the study that whilst there was a mass of upfront marketing information readily available for consumers to read on the credit product, it was very different for the PPI element. Our research highlighted that while it was easy to obtain information about credit products from a lender's branch, information specifically relating to PPI was usually given very little attention in 'pick up ' leaflets and was quite often difficult to find. Lenders have argued that increasing the level of marketing of PPI within branches (face to face is the most popular sales channel for PPI) could simply confuse consumers.

6.8 Over the internet the picture is similar. Most credit websites we visited did have a section on PPI, but in some cases it was difficult to locate and more often than not we had to find the policy summary for details about the policy, and this was often located at the bottom of the page and could easily be missed.

6.9 Whilst it is possible to find information on cover, information about exclusions tends to be more hidden and on occasions the text could effectively discourage consumers from searching out information about exclusions.

Poor upfront information on PPI prices

6.10 We did come across some good practice of lenders of unsecured loans giving consumers upfront information about the cost of PPI, setting out examples of the cost (monthly and/or total) of the credit **AND** the cost of the PPI in marketing literature. However, this was not the situation across the board and marketing literature, which consumers could use

as a starting point for weighing up whether they would get a good deal, often contained no information about the cost of PPI. As the examples at paragraph 6.16 highlight, adding PPI to the deal may significantly alter the total cost of a loan.

Poor understanding of PPI

6.11 PPI is a complex product which is relatively difficult for consumers to understand or assess. While consumers from our consumer survey, on the whole, appeared to be satisfied with the information that they received on PPI, it was telling that, when probed, many knew little about what they were paying for. For example 53 per cent of those paying for PPI monthly[43] did not know what they were paying; 34 per cent thought that there were no exclusions on the policy (and we saw no policies without exclusions) and 38 per cent did not know whether the policy contained any exclusions. Of the 27 per cent of consumers who said there were exclusions on their policy only 48 per cent could name these (13 per cent of all PPI holders).

6.12 Pre-existing conditions are a common exclusion which consumers need to be aware of, yet insurers report that these are the main reasons for turning down claims suggesting that the consumer did not know or understand what these exclusions meant. Defaqto[44] highlight the irrelevance consumers sometimes attach to pre-existing medical conditions as they may be unaware of what such `conditions' are. This could come up as an issue only once they try to claim and then discover that the policy they have purchased perhaps was not appropriate for them in the first place.

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[43] 91per cent of current PPI holders paid monthly.

[44] Payment Protection Insurance in the UK, Annual Review of the PPI market – February 2006 Defaqto Limited.

Use of a headline APR

6.13 The OFT consumer survey found that when choosing a provider and a product, **APR rate** [for the credit product] is usually the only stated discriminator, effectively ignoring any differences in the cost of the PPI or in the cover provided.

6.14 The results of our `mystery shop' exercise suggest that it is not uncommon for some distributors to make use of a headline APR to draw people into a credit deal. Consumers appear to look at the APR (the cost of credit) and not at either the cost of PPI or the cover it provides. Results from our consumer survey indicate that 22 per cent chose the product because of the APR and 16 per cent because of the 0 per cent interest or finance deal. The APR for the credit is not necessarily a good indicator of the best deal, once the PPI gets factored in.

6.15 Research by Defaqto Limited also found that some loans which have very low headline APRs become much more expensive when PPI is added to the loan. Our own research found evidence of this too.

6.16 For example, one distributor advertised an APR of 6.1 per cent for a five year unsecured loan of £5,000. Our researcher was offered an actual rate of 7.4 per cent which changed to an approximate equivalent 22 per cent when PPI was added (as a single premium), a difference of 14.6 per cent. Even where the headline rate was the same as the actual rate offered, the addition of PPI can still make a big difference to what the consumer eventually pays. For example, one distributor offered a low APR of 5.7 per cent for a similar loan of £5,000. The approximate equivalent APR including PPI was 13.7 per cent, a difference of 8 per cent.

6.17 The issue grows in significance when take up rate of PPI is high. Anecdotal evidence and responses to our business survey indicate that take-up rates for PPI on secured loans are high (perhaps as high as 70 per cent). When a consumer can neither determine the total cost of the loan with PPI added nor the quality of cover, the potential for consumers to get value for money is significantly reduced.

Poor information on product detail

6.18 We found that providers of PPI are not particularly effective at putting across key information about their products. We contacted 24 unsecured loan providers by telephone and not one mentioned the exclusions associated with their relevant PPI policies without a prompt from the caller. Not one of the unsecured loan providers mentioned to our researcher that the policy was based on a single premium without a prompt. Just one third (30 per cent) of unsecured loan providers detailed the criteria required to qualify for PPI at the quotation stage.

6.19 In some cases, particularly with secured loans, we found very little information given out unless we were prepared to go through an application stage. Even at this stage we are unsure whether a consumer would be provided with sufficiently clear information required for them to make an informed choice or whether they would be left to find their way through policy documents and terms and conditions themselves to determine whether PPI was for them, particularly given the FSA's thematic work which showed that too much reliance was placed on written disclosure.

6.20 Our view is that providing information at the application stage will in any case typically be too late, as at that time the consumer has been 'captured' having been credit checked and possibly approved for a loan, and hence may be reluctant to refuse the offering of PPI because of a perceived obligation to carry the process through. It isn't difficult to reach the conclusion that the timing of information provision, and the way in which it is presented, is likely to play an important role in consumers' choices.

6.21 Nevertheless, it should be noted that, as mentioned above, the FSA's rules require consumers to be given key information about the PPI policy in good time before the contract is concluded. If these were complied with, this ought to improve the information available to consumers to help them consider alternative products.

Lack of shopping around

6.22 Whilst 40 per cent of respondents to our consumer survey claimed to have shopped around for their credit product, just 12 per cent shopped around for the PPI. Furthermore, of those who didn't shop around for their credit product, just three per cent shopped around for PPI.

6.23 Whilst 26 per cent of mortgage PPI holders claimed to have shopped around for PPI and 13 per cent for secured loans, just 5 per cent of credit card holders, 3 per cent of store cards holders and 5 per cent those with unsecured loans had shopped around for their PPI. Given that unsecured loans earn a large/majority share of the PPI market, that only five per cent of consumers shop around for this product is of particular concern.

6.24 Many within the industry indicated that consumers are not prepared to look beyond the PPI product that is offered by the credit provider. Research by Harris International for the Finance and Leasing Authority (FLA)(2005) showed that web searches on PPI are low. We were frequently told by stakeholders that PPI is a product which is sold not bought i.e. consumers rarely set out to buy this product on its own. Instead cover is promoted in some way by the distributor of the associated credit. PPI is a secondary and even a tertiary product. This lack of shopping around might explain why, when consumers do take out PPI, the vast majority take it out with the lender who sells the credit. The consumers who indicated that they did shop around tended to be MPPI buyers. The general lack of shopping around limits the scope for competition to work to the benefit of the consumer.

6.25 Discussions with the industry suggest that consumers decide whether they can afford the PPI they are offered (in relation to their overall monthly payments) rather than whether it represents good value in comparison to other products or against bearing the risk themselves.

Point of sale advantage

6.26 The POS advantage is a key feature of the PPI sector. On average our business survey showed that overall 91 per cent of PPI policies are sold

at the POS of the credit product being insured. Distributors who we spoke to indicated that it is common for 100 per cent of unsecured loan PPI policies to be sold at POS. Credit card PPI is least likely to be sold POS (on average only 64 per cent of sales), but even there PPI tends to be sold via a follow-up exercise such as when the card is activated, which it could be argued is also POS. We only came across one stand alone provider who sold stand alone credit card PPI cover and they indicated that the number of policies sold were small.

6.27 MPPI is the only sector where the POS advantage appears weaker but even there at least one stakeholder indicated that the majority of MPPI is sold at POS. One possible answer could be that there is a stronger presence from stand alone providers. Another is that PPI products are vying with other products (e.g. life insurance, home insurance) for a slice of the consumer's limited purse – often pushing it a long way down the list of consumer's priorities. More generally, the absence of advertising reflects the POS advantage; if consumers are not actively shopping around for a good deal there is no need to advertise.

6.28 The POS advantage strengthens with the sale of single premium PPI. On the whole consumers tend to pay for the single premium PPI by adding the cost of the PPI to the loan. Whilst the consumer could look elsewhere for credit to pay for the PPI, this would involve taking out a separate credit agreement – an unlikely scenario. Our consumer survey showed that 98 per cent of those who took out a secured loan PPI (which is predominantly single premium) purchased the policy at point of sale. For unsecured loans, which again tend to be predominantly single premium, the figure is 91 per cent.

Complexity of product makes comparisons difficult

6.29 Even if consumers wanted to shop around for PPI our research shows that shopping around is not easy. The complex nature of PPI makes comparison between different policies difficult for consumers. There is a wide variety of products and prices, and PPI policies tend to include a relatively large number of terms and conditions compared with other financial products. There are wide variations in exclusions, product

structure, the way benefits are paid and use of general terminology. Our own research found cover ranging from:

- Accident and sickness only or
- Unemployment only, to
- Life, sickness, accident, unemployment some with added hospitalisation cover and carer cover.

6.30 Policies had different `waiting periods' before benefit can be claimed or paid (30, 60 or 90 days) with some benefits being accrued daily and some accrued monthly.

6.31 Such product differentiation makes it difficult for consumers to compare products on offer, even where these are aimed at similar needs. As a result consumers may pay more than is necessary and inevitably purchase, on occasion, inappropriate policies.

6.32 Product complexities were also highlighted in research by Defaqto Limited[45]which set out the different terms used throughout the industry to describe the same thing, e.g. excess period/waiting period both describe a period of time after the claim date during which the consumer is not eligible to receive benefit payments. Defaqto found that products that appear to have the same waiting period before any benefit is paid can in fact be very different, and choosing the wrong type of policy could disadvantage consumers.

6.33 We understand that some in the industry have made efforts to adopt industry standard terms and to keep exclusions and waiting periods to a minimum. However this would need to be an industry wide initiative to be successful in helping consumers to choose confidently between different products.

PPI automatically included in the quote

6.34 Our research found that nearly all unsecured loan providers [87 per cent] who we contacted automatically included PPI in the quote for the loan. For mortgage PPI the figure was lower at 40 per cent.

6.35 The FSA's rules require the consumer to be given the price of PPI separately from the price of the credit in good time before the contract is concluded. Again if these were complied with, this ought to improve the information available to consumers to help them make informed decisions.

Potential to mislead

6.36 A particularly worrying finding was that nearly a third (30 per cent) of consumers in our survey who went on to buy PPI either assumed, were told or were given the impression by the distributor that **taking out the PPI would help the application for credit**. The FSA's rules require firms to treat consumers fairly and to communicate information in a way that is clear, fair and not misleading. It is difficult to see how giving such impressions would be consistent with these rules. Whilst the number who were told by the supplier was small it is disturbing that something about the way the market is operating leads consumers to make these kinds of assumptions.

Competitive pressure on prices

6.37 We found evidence of some competitive pressure operating at the upstream end of the market with those distributors who operated a tendering process having several bidders for each contract, distributors possessing a degree of buyer power and insurers seeing a squeeze on net underwriting profits for several years. It appears that the costs of switching PPI provider in the upstream end of the market are low and many distributors indicated that they had switched insurers over the last few years. However, we saw no evidence that this pressure was feeding downstream into retail prices.

Alternative products do not appear to provide competitive pressure

6.38 Products such as income protection policies are not considered to be direct substitutes in the sense of posing a constraint on PPI prices. As we indicated earlier, they differ in their terms and conditions (tending to be longer term in nature and varying in the benefits paid e.g. do not cover unemployment). In any event, given the complexity of the PPI products and the lack of comparable information on PPI which we discussed earlier, it seems unlikely that consumers would look wider than PPI when considering the risk. Hybrid products such as the Post Office's Lifestyle Protection product may offer a competitive alternative in the long run but it is too early to assess its impact.

Point of sale advantage

6.39 The POS advantage referred to earlier means that there is little competitive pressure on PPI at the key point at which the consumer buys the insurance.

Difficulties for stand alone providers

6.40 Stand alone providers, who might otherwise be thought to offer a competitive pressure, have indicated that given the POS advantage, they have difficulty accessing consumers and face substantial start-up and marketing costs in order to try to attract sufficient volume of consumers to trade successfully over the long term. Their main sales channel is the internet. However, as the Harris International work for the FLA showed, web searches for PPI are low. Our recent business survey did not ask distributors or lenders about the proportion of PPI sales via the internet, however, we did ask a similar question during our consultation for the 2005 super-complaint. Although few respondents were able to provide much data on this, most told us that only a small number of PPI policies were sold online and that these were mostly direct/stand alone products.

6.41 Stand alone PPI providers tend to focus on mortgages where policies are more likely sold through intermediaries and consumers seem to be more

willing to shop around. However, even MPPI stand alone providers have a limited presence. Council of Mortgage Lenders (CML) data[46] shows direct sales dropping from six per cent in 2002 to only one per cent in 2005, while our consumer survey showed 63 per cent of MPPI purchasers buying from a different provider than their mortgage provider.

6.42 For credit card PPI, where premium is normally based on account balance, not having access to that balance could be a significant barrier to entry for stand alone providers. Whilst one stand alone provider has found an innovative way around this based on an allotted level of monthly cover, they have themselves indicated that this is a small part of their business. Nevertheless, it may indicate potential for innovation and improvement and, in the long term, offer the possibility of a competitive pressure. Our consumer survey found that 94 per cent of credit card PPI purchasers bought this directly from their credit card provider.

6.43 The POS advantage also means that insurers have themselves been unable to provide an alternative competitive pressure by selling direct to consumers. At least one major insurer has tried to sell directly to the consumer, but was unable to achieve reasonable penetration and pulled out of direct sales.

6.44 Intermediaries have a stronger presence in the MPPI sector and could, in theory, shop around for their clients, accessing the whole market. It is not clear that that happens in practice and anecdotal evidence suggests that many act in a similar way to distributors i.e. they do not offer consumers a choice of PPI products. On the whole they sell linked (to the credit) products (often just one) rather than picking from, say, a panel of suppliers. This appears to be a more practical way for them to operate but it also means that they are not acting as an alternative sales channel to distributors and the POS advantage is, albeit slightly weaker, nevertheless still operating.

[46] CML research 2/5/2006 Table PPI3 Mortgage payment protection policies in force.

Neither initial purchase decision, nor cancellation act as a pressure on prices – lack of switching

6.45 It could be said that in the absence of pressures from competitors, the careful weighing up of value for money by consumers before buying, or the risk of consumers cancelling the PPI could act as some pressure on prices. However, where PPI is purchased at POS it is doubtful that any careful weighing up takes place (or indeed could take place given the limited information available). Nor do most consumers appear to change their minds after the event. Our survey shows that most consumers were content with their PPI purchase even if their understanding of it was poor. Few consumers cancel (14 per cent). Consumers may have been deterred by less than proportionate refunds of premium on single premium policies. Just over one quarter (27 per cent) did not know whether they could cancel and one in ten (nine per cent) did not think that they could cancel the policy. The main reason given for cancelling a policy was because it was too expensive (43 per cent) or because the holder's situation had changed (39 per cent).

6.46 Of the small number who did cancel only sixteen per cent switched to another policy (the majority of which were MPPI consumers) however we saw no evidence that those who switched did so in order to get a better deal. As we said earlier, a lack of comparable information on other PPI products could act as a barrier to switching and the pricing of single premium policies (the consumer may not receive a *pro rata* refund) may effectively prohibit switching given the potentially high redemption costs.

6.47 It seems unlikely that present levels of cancellation or switching by consumers in this market exert any serious pressure on the prices of PPI.

Value for consumers

6.48 We have identified the following that, together, indicate that consumers may be receiving poor value from PPI.

Low claims ratios

6.49 We have defined the claims ratio as claims paid as a percentage of GWP. The market is characterised by extremely low claims ratios, particularly compared with all other insurance products. Our business survey of insurers shows that the mean claims ratio in 2005 was highest for first charge mortgage PPI (33 per cent), 18 per cent for unsecured personal loans; just 12 per cent for retail credit; 22 per cent for motor finance; 14 per cent for credit card PPI and 16 per cent for secured loan PPI. This represents a mean claims ratio of 20 per cent for all PPI policies. This was broadly in line with the figures extracted from our financial pro-forma exercise which show an overall claims ratio for the sector of 19 per cent in 2005. Over 50 per cent of insurer profits appear to be earned from unsecured personal loans. Compare these figures to comprehensive motor insurance (82 per cent of GWP), household insurance (54 per cent of GWP), pet insurance (72 per cent of GWP) and medical insurance (80 per cent of GWP).[47]

6.50 While we appreciate that it is difficult to draw direct comparisons with other insurance products, claims ratios of below 20 per cent (see below) for PPI compared to other general insurance products, are sufficiently different to be beyond questions of differences in comparability or risk.

6.51 Possible cross subsidy as between PPI and credit related income in relation to unsecured personal loans and secured loans, profit sharing[48] and common cost issues make analysis difficult and whilst we have attempted to establish where profits are going, most distributors were unable to separate out the element of their costs attributable to PPI products, which makes assessment of profitability very difficult.

6.52 Based on the financial information received, the claims ratios reported by insurers declined from around 27 per cent to 19 per cent between

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[47] Larger insurer firms, FSA return for the accident year 2005.

[48] Another issue is that profit share arrangements are sometimes in place between insurers and distributors. Consequently some of the risk of losses will effectively transfer to distributors, especially if there is a 'claw back' arrangement, if required against prior year profit share. This means that the relationship is more complicated than if insurers were bearing all the risk.

2003 and 2005. However, the benefit of this appeared to pass to distributors, as commission paid as a proportion of net earned premiums increased by around13 per cent from 52 to 65 per cent over the same period.[49]

6.53 In the absence of cost data, no estimate can be made of distributors' profitability. However, claims ratios of around 20 per cent leave over 80 per cent of GWP to cover the costs and profits of insurers and distributors. Given pressures to restrain costs, and the potential benefit of spreading costs and profit across a range of businesses within the large operators (vertical integration is a feature of the market), it seems reasonable to suggest that distributor profitability on this product is sizeable.

High commission rates

6.54 The evidence from our survey of insurers suggests that commission rates paid by insurers to downstream intermediaries (distributors and non-lending intermediaries, including profit sharing deals) look to be high by comparison with other general insurance products. For example we have anecdotal evidence to suggest that commissions paid by motor insurers can be as low as 10 per cent. By contrast, our business survey suggests that average commission rates for single premium PPI policies vary from 50 per cent of GWP for first charge mortgage PPI to 67 per cent of GWP for those selling motor finance PPI. The average commission rate for all single premium PPI policies was 59 per cent. Rates for single premium second charge mortgage, unsecured loan and retail credit PPI were 66 per cent, 59 per cent and 61 per cent respectively.

6.55 Average commission rates for regular premium PPI policies varied from 35 per cent for first charge mortgages to 70 per cent for retail credit. The average commission rates were typically lower for regular premiums

[49] From our financial pro-forma.

than single premiums, excepting retail credit PPI; with the average rate for all regular PPI polices being 53 per cent[50].

Prices for PPI differ greatly which cannot be accounted for by differences in quality

6.56 Our analyses confirmed the presence of price differentials which could not be accounted for by differences in cover offered.

6.57 Obtaining comparable information in order to reach this conclusion was actually quite difficult as PPI is complex. The wide range of policies on offer and the lack of clear information did not make it easy for an OFT researcher who knew what he was looking for. It is difficult to see how a consumer, with limited knowledge of PPI, would fare better. Nevertheless, we were able to ascertain that prices for PPI differ greatly, and to an extent which cannot be accounted for by differences in quality. This applies particularly to unsecured personal loans and credit cards, although less so for first charge mortgage PPI. For example, we found that for a £5000 unsecured loan over five years, monthly PPI repayments for an accident, sickness and unemployment policy (ASU) range from £16 to £40 with little obvious difference in the cover provided. The variation in PPI repayments for a £100k 20 year mortgage was less extreme with £32 a month for the cheapest ASU policy and £45 for the most expensive (though the most expensive is still 40 per cent more than the cheapest).

6.58 In 2004 Datamonitor[51] surveyed 50 firms providing PPI for unsecured personal loans and found that the cost for the most expensive policy premium was almost three times greater than the cheapest available PPI policy premium. London Economics on behalf of OFT recently carried out a similar analysis of more up to date Defaqto information (2006) on the cost of repaying a £5000 unsecured personal loan over four years. The cost of the most expensive cover was nearly four times more expensive than the cheapest. In the absence of a higher quality product

[50] From our business survey.
[51] Datamonitor UK Creditor Insurance 2004.

in return for a higher price, it would appear that consumers are receiving poor value for money and the market is not serving its function of keeping prices in check.

Cross subsidy between PPI and underlying credit products

6.59 We received anecdotal evidence that some unsecured personal loan providers, and possibly some credit card providers are offsetting low margins on their credit offerings with profits generated from the sale of PPI. The distributors we spoke to differed in their response as to whether or not this happens. Our research suggests that, broadly there may be some evidence of unsecured loans with very low APRs being loaded with expensive PPI policies, although the evidence is far from clear cut. So, for example, we found a £5000 loan payable over 5 years with an APR of 6.7 per cent where the total cost of the loan without PPI was £5934. By adding the £2106 PPI policy (ASU) the total cost of the loan with PPI was £8040 (PPI accounts for 26 per cent of the overall cost). This compares with an equivalent loan with an APR of 16.9 per cent, costing £7271 without PPI, rising to £9067 once the PPI policy of £1789 is added. On the surface still an expensive PPI policy compared to some, but accounting for a smaller proportion of the overall cost (19 per cent). We have seen examples of apparently similar combinations of credit and PPI with greatly differing prices for the credit, for the PPI or both. Cross subsidy is possible, particularly where penetration of PPI is high. Without carrying out a detailed examination of the underlying costs [of sourcing the credit] we have not been able to reach firm conclusions.

6.60 A possible outcome of this practice is that it could exacerbate the extent to which consumers are misled by the APR about which is the best credit and PPI deal. If there is cross-subsidy it also could be argued that those consumers who do not take out PPI (which could be over 50 per cent for some types of PPI) are effectively being subsidised by those who do.

Claims

6.61 As the low claims ratios imply, few people claim on a PPI policy. Of the consumers contacted during our consumer survey (over 1000) only 126 had **ever** made a claim on a PPI policy and only 38 had claimed on a policy that had been taken out since January 2005. However, it should be noted that when a claim is made many consumers (64 per cent) were satisfied with the outcome. Two-thirds of consumers also received a reply from their insurer in less than a month regarding their claim. It was notable, however, that given the concerns raised earlier about available information that of those who had their claim rejected, two in five had it rejected because they did not meet the criteria. This indicates that they had either forgotten what the policy covered or had not been informed correctly. Insurers from our business survey indicated that the most common reason for turning down a claim was due to a pre-existing condition. Something the consumer should have been made aware of.

Scope for consumer savings

6.62 In view of the market features outlined previously, it is likely that there is significant consumer detriment associated with the sale of PPI. We have identified three ways in which the economic interests of consumers may be adversely affected.

i) Product suitability – as a result of product complexity and a lack of information transparency on price and quality products may not be suitable for some consumers although the FSA's rules and supervision and enforcement work should help address this.

ii) High (if not excessive) prices – consumers may be paying too much for their PPI as reflected in low claims ratios[52] and high rates of commission relative to other lines of general insurance.

iii) Refunds- if these do not reflect incurred costs and consumer risk profile then they may be unfair.

6.63 By using the current average claims ratio for the PPI sector and then hypothesising what the average claims ratio might look like in a competitive market (i.e. relatively high profits would be competed away in a more competitive market increasing the claims ratio as a result), we have, albeit simplistically and with the limited data available, estimated that the potential consumer savings from making the market more competitive could be around £1bn. Competition would have to increase substantially for these savings to be gained over time.

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[52] Although the absence of cost data means that we do not have an estimate of profit, the available premium income and claims data provide useful indicators. As the claims ratio is lower than in some other insurance types, the PPI sector will have relatively less revenue absorbed by claims and hence greater potential for higher profit than in those areas, [unless costs are significantly higher]. The average PPI claims ratio in 2005 ranges from 14 per cent for store card PPI to 36 per cent for MPPI. The claims ratio for personal loan PPI (the largest PPI market) is 18 per cent.

7 PROPOSED DECISION ON A REFERENCE

7.1 In order to make a market investigation reference, the OFT must have reasonable grounds for suspecting that any feature or combination of features of a market in the UK for goods or services, prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK (the 'section 131 test'). Where this threshold is met, the OFT has discretion as to whether in fact to make a reference. This section sets out the two stages of our decision making process.

The section 131 test

7.2 Section 131 sets out the three types of market feature that could have an adverse effect on competition: structural features, conduct of firms, conduct of consumers. Our guidance says that there will often not be clear separation between structural features and those relating to conduct, and the evidence supporting a reference set out in Chapter 6 covers both together, but here we summarise the features which in our view form the basis for a reference and meet s131 test under these three heads. In addition we set out performance indicators (e.g. on pricing) which the guidance says can be a useful supplement in assessing the case for a reference.

7.3 Structural features adversely affecting competition:

- PPI is a secondary (or even tertiary) purchase, typically bought only as a result of buying a primary product e.g. the credit, its demand derived from demand for the credit product. While the mere fact of being a secondary purchase would not normally be a feature adversely affecting competition, our view is that the nature of this secondary market, in conjunction with other features, does make it one in this case

- the inherent complexity of PPI [para 6.29] is another feature which would not necessarily have an adverse effect on competition, but (particularly linked to features concerning information, under all three heads) our view is that in this case it does

- it is a natural feature of many markets that suppliers have more information than their customers about the quality and other attributes of their products. The OFT guidance notes that this will not necessarily adversely affect competition, particularly if suppliers have an incentive to provide consumers with relevant information. These incentives do not appear to exist sufficiently on PPI [paras 6.7, 6.11, 6.18] and our view is that that together with complexity of the product means there is an information asymmetry that adversely affects competition although to some extent this may be addressed by FSA regulation

- the central feature adversely affecting competition in this market is a very large POS advantage [para 6.26, 6.39]. It is the feature to which most other features link in some way, and which appears to give rise most directly to low claims ratios and the other indicators in paragraph 1.4 that competition is adversely affected

- inherent barriers and costs to consumer switching on PPI [para 6.45] are a structural feature adversely affecting competition (reinforced by barriers/costs resulting from firms' conduct)

- vertical integration is a significant feature of this market with around 60 per cent of the market undertaking both the underwriting and the distribution of PPI within the same group. We suspect that this may reduce the level of direct competitive pressure on those organisations in respect of rates or product design.

7.4 Conduct of firms adversely affecting competition:

- the striking feature of these markets is that with very few exceptions competition does not take place on PPI at all. Rather, competition is on sale of the credit product and only a single insurer's PPI product is offered for sale [para 6.26] on whatever terms the lender makes available. It is obvious to all lenders that selling an add-on product for which there is no effective competition is to the advantage of each of them, and all they need to do is to avoid disturbing that situation

- firms do not generally make information available in ways that would help informed choice [paras 6.7, 6.11, 6.18,], even if customers were to show a greater propensity to shop around

- given the proportion of customers who thought taking out PPI would help their application for credit [para 6.36], we believe that there is an onus on lenders to make clear that that is not the case; and that failure to do so is a feature adversely affecting competition

- firms practices in giving refunds which do not reflect cost or consumer risk profile on cancellation of single premium PPI [para 6.45] reinforce inherent barriers and costs to consumer switching on PPI.

7.5 Conduct of consumers adversely affecting competition:

- consumers tend not to actively seek out information on PPI nor do they shop around, particularly when compared to the credit [para 6.22]. They would appear to regard search costs on such a complex product as too high against expected cost of PPI: but search is already more difficult because of the ways firms make information available.

7.6 Performance information indicating competition is adversely affected:

- claims ratios on PPI are remarkably low [para 6.49]. We are aware of the arguments of some firms that we should not have too great a regard to claims ratios as they are cyclical, affected by macroeconomic factors, reflect different cost structures on different types of insurance, and may be partly offset by cross-subsidy between credit offering and PPI. Our view is that with such low claims ratios when compared to other insurance products, and with no evidence to suggest costs are high, it seems reasonable to assume that distributor profitability is sizeable with little evidence that this is being competed away

- evidence on commission rates [para 6.54] strongly reinforces this conclusion

- the fact that considerable price variations do not appear to reflect differences in quality is a further indication that the market is affected by adverse features.

Appropriateness of a reference

7.7 Given our view that the section 131 test for making a reference is met, the decision on whether to make a reference rests on the exercise of the OFT's discretion. The OFT's guidance on market investigation references sets out four criteria that must in our view, be met before we decide to make a reference:[53]

- proportionality – the scale of the suspected problem, in terms of its adverse affect on competition, is such that a reference would be an appropriate response to it
- availability of remedies – there is a reasonable chance that appropriate remedies will be available
- alternative powers – it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT, and
- undertakings in lieu – it would not be more appropriate to address the problem identified by means of undertakings in lieu of reference.

These four factors are considered below.

Proportionality

7.8 A critical factor in assessing whether a reference is appropriate is whether it is proportionate to the scale of the concerns identified. The OFT guidance identifies three criteria as relevant to whether adverse effects on competition are significant, and thus whether a reference to

[53] OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

the CC may be appropriate. These three criteria are in our view met by the supply of PPI.

7.9 First, we recognise that a reference to the CC would have considerable resource implications for the CC itself, and impose a substantial burden on the businesses affected. The market for PPI in the UK, is however, worth some £5.5 billion annually with around 6.5 to 7.5 million policies being taken out annually. The benefits of remedying any adverse effects which might be found to exist could, therefore, be expected to outweigh these costs: indeed consumer detriment appears to be a significant fraction of the total market value. Second, a significant proportion of the market is affected by the features that prevent, restrict or distort competition: the features identified generally apply across the market and while some, such as the POS advantage, appear to be less marked within the MPPI sector they are still present. Third, the features identified as adversely affecting competition are unlikely to be short-lived: while there is some evidence that the industry is taking steps to improve the situation for consumers, for example, providing better information, they are not in our view sufficient to address all of the features we have identified or to make major improvements to competition in the market.

Availability of remedies

7.10 We have thought hard as to whether there are potential remedies available to meet the competition concerns we have outlined (and we are aware that the industry itself and the FSA have considered if there are routes to making the market operate more competitively – in addition to their primary dialogue on conduct of business concerns). We believe there are potential remedies that might contribute to such a solution but identifying the best combination is far from straightforward:

- all the indications are that a number of measures would be needed: there is no magic bullet

- interactions have to be worked through: for example, how much effect will some other remedies have if consumers cannot at the

same time be stimulated to shop around and make informed choices?

- some possible measures would have significant trade-offs: for example, requiring separation of PPI sale from credit sale (to address POS advantage) would appear likely to increase costs

- while preferred remedies would naturally be aimed at strengthening competition in the market, realistic assessment is needed on how far that is achievable; and perhaps alternative measures are needed to address the consequences if competition is likely to remain limited

- the optimum set of measures on PPI may differ in the different credit product sectors.

7.11 It is the CC's role, if it finds that there are adverse effects on competition, to do the detailed analysis of the causes and devise the optimal suite of potential remedies taking into account interactions, which would be for further detailed consultation. At least some of what may be required is likely to involve CC order-making powers to impose remedies or at least to orchestrate their implementation.

Alternative powers

7.12 We have considered whether it would be more appropriate for the OFT to use alternative powers to deal with certain features of the market(s) identified above. None of the evidence points to the possibility of using powers available to OFT to deal with the features identified. There is no indication that any individual agreement or conduct meets the threshold for enforcement of Article 81 and/or Article 82 of the EC Treaty or of the CA98, nor are we aware of any breaches of the Consumer Credit Act 1974 to justify enforcement action.

7.13 Since January 2005 the FSA has regulated the sale of PPI and has carried out two rounds of thematic work assessing whether firms were complying with FSA rules, particularly conduct of business and training and competence rules, and whether firms were treating their consumers

fairly. Since the findings from the first round (which showed that in some sectors selling practices were poor), the FSA has been working with the industry to try to secure improvements. However there are a number of questions on how far FSA powers might form part of a package of measures to encourage the market to operate more competitively:

- as set out above, more still needs to be done to establish what the best mix of measures would be

- there are procedures and timing implications around the possible use of FSA powers. In particular, the FSA has a statutory duty to carry out cost-benefit analysis and public consultation before making rules unless the delay involved would prejudice consumers' interests.

- there are questions how far FSA powers could be used for such purposes: competition does not feature among FSA's regulatory objectives (but in discharging its general functions it must, amongst other matters, have regard to the desirability of facilitating competition among those it regulates). However, the FSA has a regulatory objective to provide appropriate consumer protection, and to the extent that any remedies are necessary or expedient to provide this protection the FSA could implement them.

7.14 In practice, where there is an overlap of FSA and competition authority powers, it may be more appropriate for the competition authorities to address problems that derive primarily from pricing and competition concerns. If it was concluded that competition could not be strengthened, and that the only remedies are ones that limit consumer detriment then the FSA might have powers to do this. However, given the FSA does not have an objective to promote competition and the competition concerns we have about the PPI market we do not believe that the FSA's consumer protection powers nor its on-going liaison with trade associations make a market investigation reference inappropriate.

Undertakings in lieu of reference

7.15 Finally, we need to take account of the possible undertakings in lieu (UIL) of a reference that could be offered by the industry to address the concerns raised without the need for a market investigation reference.

7.16 As set out above, we have not been able to reach a view on what would be an effective set of remedies. Even if we had, this is a large and complex market with a diverse set of businesses ranging from large insurers to significantly smaller intermediaries, and negotiating undertakings would be a massive exercise. We therefore believe that this is a case where it is unlikely that undertakings would offer a comprehensive solution. However, we would of course consider any undertakings that were offered by parties in the light of this consultation.

Conclusions on the case for a reference

7.17 Taking account of the relevant factors outlined in the OFT's guidance document on market investigation references, we believe that the statutory test for a reference is met and the balance of arguments points in favour of exercising our discretion to make a reference to the CC of the supply in the UK of PPI on all credit products, except that we are minded to exclude PPI on store cards. (Store card PPI has recently been looked at by the CC[54] in the context of the store card market investigation reference and there are therefore arguments that it would not be reasonable to include it within the scope of the proposed reference. However there are arguments the other way, not least convenience for parties who might not always find it easy to divide data between different types of PPI or might want to draw attention to similarities and dissimilarities between store card and other PPI. We are inclined to exclude store cards PPI but would welcome views on the matter).

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[54] www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm